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GENERAL

OLL 84-4020/1
31 October 1984

MEMORANDUM FOR: Chief, Administrative Law Division
Office of General Counsel

ATTENTION:

FROM:

Chief, Legislation Division
Office of Legislative Liaison

SUBJECT: Federal Government's Audit Process

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1. Attached for your review is a letter from Congressman Jack Brooks, Chairman of the House Government Operations Committee, enclosing a report entitled "Questionable Decisions by Program Managers Undermine the Federal Government's Audit Process." Chairman Brooks requests in this letter that the Agency report on actions planned or taken in response to the report's recommendations.

2. I would appreciate your reviewing the attached report carefully to determine if any Agency response is necessary, and the form that response should take. As the Committee has asked us to respond by 21 November 1984, your prompt attention to this matter is requested.

3. Please do not hesitate to call [] if I can be of further assistance.

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Attachment

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LEGISLATIVE LIAISON

84-4020

Honorable William J. Casey
 Director
 Central Intelligence Agency
 Washington, D.C. 20505

Dear Mr. Casey:

Enclosed is a copy of the report approved by the Committee on Government Operations entitled, "Questionable Decisions by Program Managers Undermine the Federal Government's Audit Process."

The report is the result of the Legislation and National Security Subcommittee's review and August 8, 1984 hearing concerning Federal agencies' audit resolution policies and procedures. It contains recommendations intended to assure the proper resolution of audit findings. While these recommendations are addressed primarily to the Office of Management and Budget, the report also recommends that all Federal audit organizations establish and maintain appropriate systems for determining whether necessary corrective actions are taken on audit findings and recommendations.

I would appreciate your advising the Committee within 30 days as to the actions you have taken or plan to take in response to the report's recommendations. With every good wish, I am

Sincerely,

[Signature of Jack Brooks]

JACK BROOKS
 Chairman

Enclosure

Brooks Letter

Union Calendar 622

98th Congress, 2d Session - - - - -

House Report 98-1106

**QUESTIONABLE DECISIONS BY PROGRAM MANAGERS
UNDERMINE THE FEDERAL GOVERNMENT'S
AUDIT PROCESS**

FORTY-SIXTH REPORT

BY THE

**COMMITTEE ON GOVERNMENT
OPERATIONS**



SEPTEMBER 28, 1984.—Committed to the Committee of the Whole House on the State of the Union and ordered to be printed

U.S. GOVERNMENT PRINTING OFFICE

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WASHINGTON : 1984

Committee Report

Union Calendar 622

98TH CONGRESS
2d Session

HOUSE OF REPRESENTATIVES

REPORT
98-1106

QUESTIONABLE DECISIONS BY PROGRAM MANAGERS UNDERMINE THE FEDERAL GOVERNMENT'S AUDIT PROCESS

SEPTEMBER 28, 1984.—Committed to the Committee of the Whole House on the State of the Union and ordered to be printed

Mr. BROOKS, from the Committee on Government Operations,
submitted the following

FORTY-SIXTH REPORT

BASED ON A STUDY BY THE LEGISLATION AND NATIONAL SECURITY
SUBCOMMITTEE

On September 25, 1984, the Committee on Government Operations approved and adopted a report entitled "Questionable Decisions by Program Managers Undermine the Federal Government's Audit Process." The chairman was directed to transmit a copy to the Speaker of the House.

I. SUMMARY

This report is the result of a study by the Legislation and National Security Subcommittee on the efficiency and effectiveness of Federal agencies' audit resolution policies and procedures. In performing this evaluation, the Subcommittee focused its efforts on determining the reasons for the frequently large disparity between the amount of expenditures questioned by auditors reviewing grant recipients and contractors and the amount of these questioned costs that Federal program officials agree should be returned to the Federal Government. The report is based on hearings conducted by the Subcommittee and a review performed by the General Accounting Office (GAO).¹

Federal program managers disallow only 30 to 40 percent of the grantee and contractor expenditures questioned by auditors. ("Dis-

¹ GAO Report, "Audits of Federal Programs: Reasons for the Disparity Between Costs Questioned by Auditors and Amounts Agencies Disallow," AFMD-84-57, August 8, 1984.

allowed costs" are those for which the program manager agrees with the auditors' findings that Federal funds have been misspent and should be recovered; "allowed costs" are those for which the manager decides in favor of the auditee and does not seek recovery of the funds. Disallowing questioned costs is also referred to as "sustaining" auditors' findings.) A significant portion of this disparity between questioned costs and disallowed costs is the result of questionable decisions by program managers on audit findings and recommendations. In the 325 audits reviewed, about 25 percent of managers' decisions to allow questioned costs appeared inappropriate in that they did not hold the auditee accountable for correcting identified deficiencies, did not address the issues raised by auditors, or were not supported by adequate justification. These questionable decisions involved \$163 million. Additional audit resolution guidance from the Office of Management and Budget (OMB) is needed to help ensure that program managers make sound decisions on auditors' findings and recommendations.

Other factors contributing to the disparity between questioned costs and disallowed costs include:

- The allowance of questioned costs on the basis of documentation submitted to program managers after the completion of an audit;

- Differing interpretations of applicable laws and regulations by auditors and program managers;

- Possible lack of auditor participation in the resolution process; and

- Questions of audit quality.

The basic audit resolution policies and procedures for Federal agencies are prescribed by OMB Circular A-50. The definition of audit resolution in the Circular, however, is not consistent with the audit resolution standard developed by the Comptroller General pursuant to the Federal Managers' Financial Integrity Act of 1982. The Comptroller General's standard specifies that audit findings and recommendations are not to be considered resolved until actions which correct the deficiencies identified in audit reports are completed. Circular A-50, however, defines resolution as simply the point at which a final determination is reached on the actions to be taken. The definition in Circular A-50 is seriously flawed and should be revised to incorporate the Comptroller General's audit resolution standard.

II. INTRODUCTION

A. IMPORTANCE OF AUDIT RESOLUTION

The Federal Government relies on auditing as one of the principal means of ensuring accountability in the use of Federal tax dollars. A completed audit report, however, represents only the first step in the audit process; it does not include final decisions on whether Federal funds have been spent in accordance with applicable statutes and regulations. Audit reports simply contain the findings and recommendations of auditors for use by Federal officials responsible for administering the programs under review. The second step of the audit process is taken by these program manag-

ers who make the actual determinations on the appropriateness of the expenditures in question. In making these determinations, program managers have considerable discretion to either accept or reject auditors' findings and recommendations.

This critical second step of the audit process—reviewing audit reports, making final determinations, and where necessary, taking appropriate actions to assure that the deficiencies identified by auditors are corrected—is referred to as “audit resolution.” According to the audit resolution standard developed by the Comptroller General pursuant to the Federal Managers' Financial Integrity Act of 1982 (31 U.S.C. 3512(b)), in resolving audit findings:

Managers are to (1) promptly evaluate findings and recommendations reported by auditors, (2) determine proper actions in response to audit findings and recommendations, and (3) complete, within established time frames, all actions that correct or otherwise resolve the matters brought to management's attention.²

B. PREVIOUS COMMITTEE REVIEWS OF AUDIT RESOLUTION

The Committee on Government Operations has played a key role in the development of Federal audit resolution policies and procedures. This report is the fourth the Committee has issued on the subject in the past five years. The earlier reports, which were also based on hearings by the Legislation and National Security Subcommittee and studies by the General Accounting Office, are briefly summarized here.

1. 1979 Report: *“Failure of Government Departments and Agencies to Follow Up and Resolve Audit Findings”*

In a report issued in June 1979 the Committee concluded that: “Followup and resolution of audit reports has been untimely and ineffective.”³ According to a GAO review of 34 agencies, as of March 1977 over 14,000 audit reports involving potential recoveries of funds from grantees and contractors or other cost savings totaling more than \$4.3 billion had not been resolved.⁴ The Committee found that the agencies' poor performance in resolving audit findings and recommendations was due to:

(1) The lack of management systems to track and control audit findings; (2) the low priority assigned to audit resolution by agency management; and (3) agency procedures which permit officials responsible for the program audited to decide final action on audit findings and recommendations without proper oversight and control.⁵

The Committee recommended that OMB, the Department of Defense (DOD), and Office of Personnel Management (OPM) take specific actions to upgrade Federal audit resolution systems. In re-

² GAO, “Standards for Internal Controls in the Federal Government,” 1983, p. 12.

³ “Failure of Government Departments and Agencies to Follow Up and Resolve Audit Findings,” Committee on Government Operations, House Report No. 96-279, 96th Congress, 1st Session, June 18, 1979, p. 3.

⁴ GAO Report, “More Effective Action is Needed on Auditors' Findings—Millions Can Be Collected or Saved,” FGMSD-79-3, October 25, 1978, p. 4.

⁵ Ibid. note 3, p. 2.

sponse to the report, the three revised their policies and procedures to incorporate many, though not all, of the Committee's recommendations.

2. 1981 Report: "Continued Failure of Departments and Agencies to Take Effective Action on Audit Findings"

In an October 1981 report following up on its earlier review, the Committee concluded that, "The resolution of audit findings in the Federal Government is still ineffective and untimely."⁶ The situation had, in fact, worsened. As of July 1980, the amount of unresolved audit findings in the 34 agencies reviewed in 1977 had increased to \$14.3 billion.⁷ The Committee found that audit resolution continued to be a low priority in many agencies and that procedures to ensure the timely and effective resolution of audit reports were either not in place or were not being followed. Recommendations designed to improve agencies' performance were again addressed to OMB, DOD, and OPM.

3. 1982 Report: "Failure of Federal Departments and Agencies to Collect Audit-Related Debts"

In August 1982 the Committee issued a report on the final step of the audit resolution process—the actual collection of debts resulting from audits of grantees and contractors. The Committee found that agencies' debt collection systems were so deficient that the total amount of audit-related debt could not be determined, and much of the \$374 million of such debt that was identified had gone uncollected for years. The report concluded that, "Fundamental weaknesses in accounting for and collecting audit-related debts diminish the effectiveness of the audit process and cost the Government hundreds of millions of dollars in recoverable expenditures."⁸ The Committee recommended that OMB take several specific actions to strengthen agencies' debt collection procedures.

C. OMB CIRCULAR A-50

The Federal Government's basic audit resolution policies and procedures are contained in OMB Circular A-50. In September 1982 OMB issued a revision of the Circular, incorporating many of the recommendations from the Committee's previous audit resolution reports.⁹

Under the provisions of Circular A-50, agencies are to "establish systems to assure the prompt and proper resolution and implementation of audit recommendations." Each agency's audit resolution system must:

⁶ "Continued Failure of Departments and Agencies to Take Effective Action on Audit Findings." Committee on Government Operations, House Report No. 97-279, 97th Congress, 1st Session, October 20, 1981, p. 4.

⁷ GAO Report, "Disappointing Progress in Improving Systems for Resolving Billions in Audit Findings," AFMD-81-27, January 23, 1981, p. 6.

⁸ "Failure of Federal Departments and Agencies to Collect Audit-Related Debts." Committee on Government Operations, House Report No. 97-727, 97th Congress, 2nd Session, August 12, 1982, p. 13.

⁹ Note: Prior to September 1982, Federal audit resolution policies and procedures for audits conducted by and for Executive Branch agencies were contained in Circular A-73. Circular A-50 provided guidance for agency action on GAO audit reports. The revised Circular A-50 provides guidance for follow up on both types of audits.

Provide for the appointment of an "audit followup official" with overall responsibility for audit resolution within the agency;

Require that program managers make decisions on audit findings and recommendations within six months after the issuance of an audit report and take prompt corrective actions when necessary;

Specify criteria for proper resolution and corrective action on audit findings and recommendations;

Maintain accurate records on the status of audit reports through the entire process of resolution and corrective action, including accounting and collection controls over audit-related debts;

Assure that disputes between program managers and auditors over audit findings and recommendations are resolved by either a higher level management official or the audit followup official;

Assure that audit resolution actions are consistent with applicable laws, regulations, and policies, and that decisions on audit findings and recommendations are adequately documented;

Provide for procedures to coordinate resolution and corrective action on recommendations involving more than one program, agency, or level of government;

Assure that semi-annual reports on the agency's audit resolution activities are provided to the agency head;

Provide for periodic analyses of audit recommendations, resolutions, and corrective actions, to identify systemic problems requiring attention and to recommend solutions;

Assure that the performance appraisals of officials involved in the audit resolution process include an evaluation of their effectiveness in following up on audit findings and recommendations; and

Provide for periodic evaluations of the system's efficiency and effectiveness.

The definition of audit resolution in Circular A-50 is not consistent with the audit resolutions standard developed by the Comptroller General pursuant to the Federal Managers' Financial Integrity Act of 1982. While the GAO standard emphasizes that an audit is "resolved" only after appropriate corrective actions on the auditors' findings and recommendations have been completed, Circular A-50 defines resolution as simply the point at which agreement is reached on the action to be taken. This inconsistency is discussed in greater detail later in this report.

D. DISPARITY BETWEEN QUESTIONED COSTS AND DISALLOWED COSTS

During the course of its earlier evaluations of agencies' audit resolution procedures, the Committee found that there is frequently a large disparity between the amount of expenditures questioned by auditors reviewing grant recipients and contractors and the amount of these questioned costs that Federal program managers agree should be returned to the Federal Government. This disparity raises serious questions regarding the appropriateness of pro-

gram managers' decisions on auditors' findings and the quality of the audits involved. As a result, in August 1982, Chairman Jack Brooks asked GAO to determine the reasons for this disparity.

On August 8, 1984, the Legislation and National Security Subcommittee held a hearing to review the findings and recommendations of the GAO study and to examine the procedures used by program managers to resolve audits. Witnesses included Frederick D. Wolf, Director of GAO's Accounting and Financial Management Division, and Joseph R. Wright, Jr., Deputy Director of the Office of Management and Budget.

III. DISCUSSION

A. EXTENT OF THE DISPARITY BETWEEN QUESTIONED COSTS AND DISALLOWED COSTS

Program managers disallow only 31 percent of the expenditures questioned by auditors, according to the GAO study requested by Chairman Brooks. These conclusions were based on an evaluation of audit resolution procedures at six major Federal agencies—the Departments of Agriculture, Labor, Transportation, Health and Human Services, Education, and the Environmental Protection Agency. From 325 audits of grantees and contractors conducted by Inspectors General and other Federal audit officials, State and local auditors, and independent public accountants, 586 findings were selected and analyzed. These findings involved \$667 million in questioned costs. Program managers disallowed \$207 million, or 31 percent, of these costs; they allowed \$470 million, or 69 percent.¹⁰

These findings are consistent with those of a 1978 GAO report on audit resolution,¹¹ as well as with those of a report issued by OMB in August 1983.¹² In 1978, GAO reported that program managers agreed with auditors' findings on only 38 percent of the questioned costs identified in audit reports. OMB's report, which was based on the work of an inter-agency project evaluating audit resolution procedures, concluded that program managers disallow only about 40 percent of the expenditures questioned by auditors.

B. REASONS FOR THE DISPARITY BETWEEN QUESTIONED COSTS AND DISALLOWED COSTS

1. *Questionable decisions by program managers*

Program managers frequently use questionable procedures in deciding to allow grantee and contractor expenditures questioned by auditors. As noted above, GAO reviewed program managers' decisions on 586 audit findings. On 424 of these findings, involving a total of \$470 million in questioned costs, managers did not sustain the auditors' position. The audit resolution procedures followed in 112 of the 424 decisions were questionable. These 112 decisions involved \$163 million. "Questionable" procedures are those that do not hold the auditee accountable for correcting deficiencies identified by audit reports, do not address the issues raised by auditors,

¹⁰ Ibid, note 1, p. ii.

¹¹ Ibid, note 4, p. 8.

¹² OMB report, "Improving the Quality of Audit Resolution," August 1983, p. 1.

or are not supported by appropriate justification. Examples of such procedures are discussed below.

a. Failure to hold auditee accountable for identified deficiencies

Twenty-one of the 112 questionable decisions identified by GAO involved program managers allowing questioned costs on the basis of a proposed reaudit of a grantee or contractor. These 21 decisions involved \$72.9 million. For example, Federal auditors reviewing an EPA grant to a State pollution control agency questioned \$720,000 because of deficiencies in the grantee's accounting system. Although program managers did not dispute the auditors' findings, they requested that the grantee be reaudited, and, on the basis of that request, they allowed the questioned costs. However, since the audit workplan of the EPA Office of Inspector General no longer includes audits of this type of grant, the funds will never be reaudited. As a result, the effort expended on the original audit was wasted.

While there are situations in which a reaudit of a grantee or contractor may be necessary—for example, when the auditee develops documentation of expenditures that was not available at the time of the audit—allowing questioned costs simply on the basis of a proposal to reaudit at a later date is inappropriate. As the EPA audit illustrates, the proposed reaudit may never be performed. In addition, even if the reaudit is conducted, it may not address the problems that resulted in expenditures being questioned in the original audit. The Committee believes that when a reaudit is deemed necessary, the reaudit should be timely and the original audit report should be held open until the reaudit is completed and a final determination can be made.

Program managers sometimes allow questioned costs on the basis of corrective action plans developed by the auditee to eliminate the deficiencies identified by auditors. In accepting such plans the Federal Government is, in effect, foregoing the recovery of Federal funds in return for a promise of improved future performance by the auditee. In 13 of the 112 questionable decisions, however, program managers allowed a total of \$11.5 million in questioned costs on the basis of plans that were vague, did not address the problems identified by auditors, or were never implemented. Accepting corrective action plans with these types of weaknesses does not adequately protect the Federal Government's interests.

In one case, a Department of Labor (DOL) audit questioned \$4.2 million because of the grantee's failure to meet the training requirements of a DOL program. The costs were allowed on the basis of a corrective action plan in which the grantee promised to monitor training and provide technical assistance to subrecipients. The plan, however, provided no specific details on how the promised improvements would be achieved. Accepting vague corrective action plans that do not identify specific actions to be taken and timetables for completing such actions makes it difficult to monitor an auditee's performance and to hold it accountable for actually correcting deficiencies.

In another case, Department of Transportation auditors questioned about \$150,000 in grant funds used to purchase bus stop

signs when they discovered that the signs had not been installed. Program managers allowed the costs on the basis of their request that the grantee provide, within six months, detailed written assurances that the signs had been installed. More than a year later the promised documentation had not been received. As a result, program officials did not know whether the signs were in place. Nevertheless, the questioned costs were not reclassified as "disallowed," and no effort was made to recover the grant funds.

The Committee realizes that corrective action plans can play a useful role in the audit resolution process in helping to assure that deficiencies identified by auditors are eliminated. These plans must, however, be used very carefully if the Federal Government's interests are to be adequately protected. Promises of corrective actions should not be accepted in lieu of recovery of Federal funds that have been misspent. In addition, when corrective action plans are used in cases requiring remedial action by the auditee—such as in the "stop sign case" discussed above—a determination on the questioned costs should be withheld until the necessary measures are actually implemented. The Committee realizes that in some situations this approach may prevent Federal agencies from reaching a determination on audit findings within the six month period prescribed by Circular A-50. However, allowing questioned costs prior to the completion of corrective action greatly reduces auditees' incentive to follow through on their commitments to eliminate deficiencies in their operations.

b. Failure to adequately address issues raised by auditors

In 47 of the 112 questionable decisions, program managers allowed questioned costs without adequately addressing the auditors' findings and recommendations. These cases involved \$61.9 million in questioned costs. For example, in one case Department of Labor program officials allowed \$18.2 million on the basis of a program provision authorizing managers to allow questioned costs under certain circumstances if the funds involved are not "substantial." The term "substantial" was not defined. In the Subcommittee's hearings, Frederick D. Wolf, Director of GAO's Accounting and Financial Management Division, commented on this case:

. . . No one has explained to me how \$18 million is inconsequential, but even if it is, the fact remains that no one has ever really addressed the issue of whether the costs were, in fact, allowable.¹³

In another case, Department of Education (DOEd) auditors questioned \$12.3 million because of violations of grant requirements. The grantee then filed a \$12.3 million lawsuit against the Department over an unrelated issue. DOEd program officials responded by negotiating a settlement in which the Department agreed to allow the questioned costs in return for the grantee dropping its lawsuit. The substantive issues raised by the audit report were never addressed.

¹³ Hearing on "Federal Agencies' Audit Resolution Procedures," before the Legislation and National Security Subcommittee of the Committee on Government Operations, August 8, 1984. Proceedings of the Hearing are to be published subsequent to this report; accordingly, references are to the stenographic transcript.

One must question the judgment of program officials who arbitrarily write off questionable expenditures amounting to millions of dollars. The Committee believes that examples such as these highlight the need for auditors to review program managers' decisions and, when they disagree, request a review of the program manager's decision by an impartial third party within the agency. This procedure is currently prescribed by OMB Circular A-50.

c. Failure to support determinations with appropriate justification

In 31 cases, involving \$16.2 million in questioned costs, program managers did not provide appropriate justification for their decisions to allow the expenditures questioned by auditors.

Auditors frequently question the use of Federal funds because the expenditures have not been adequately documented. In such cases auditees often submit additional documentation to program officials after the audit is completed. The managers can use the new information in making a determination on the questioned costs. Sometimes, even if an auditee is unable to provide additional documentation after the audit, program managers will allow questioned costs on the basis of auditee "certifications" that the funds were, in fact, spent properly. There are problems with the use of both of these procedures.

With respect to the use of post-audit documentation submitted by auditees, there were several cases in the analyzed findings in which programs managers allowed questioned costs even though the information supplied to them was insufficient to support the auditee's claim that the funds were spent in accordance with applicable requirements. For example, an EPA audit of the department of natural resources of one of the states questioned \$5.9 million for a three-year period because of deficiencies in the grantee's financial management system. Program officials allowed the entire \$5.9 million based on a review of grantee-supplied documentation covering only \$2.3 million of the questioned costs and only one year of the three-year period. This limited review was insufficient and did not justify allowing the entire amount, particularly in light of the fact that the costs were questioned because of deficiencies in the grantee's financial management system.

In a case involving auditee certifications, a Department of Education audit questioned \$5 million in contract expenditures by a major university because the contractor had not maintained adequate documentation. Nevertheless, program managers allowed the questioned costs when the university certified that the funds had been spent properly. Certifications are at times justifiable; however, they should be accepted only in very limited circumstances—for example, when the auditee's records have been destroyed by fire—and should not be accepted simply because the auditee does not maintain adequate accounting and financial management systems to document its expenditures of Federal funds. Accepting certifications in any but the most extreme circumstances can reduce an auditee's incentive to maintain adequate records of the expenditure of Federal funds. Of ever greater concern to the Committee is that the use of certifications undermines the entire audit process. Program managers can help reduce the need to rely on certifications

by assuring at the outset of a grant or contract that the grantee or contractor has adequate accounting and financial management systems to document its expenditures.

GAO found several instances in which program officials did not provide adequate written justification for their decisions to reject auditors' findings, despite the fact that OMB audit resolution policies and procedures require such documentation. While OMB indicated in materials submitted for the hearing record that Federal agencies have reported that audit determinations are generally documented adequately, OMB's August 1983 report on audit resolution reached a different conclusion:

The study revealed that agencies generally do not document the audit resolution decisions. Furthermore, even if there is a written determination for the decision, the supporting evidence is usually lacking.¹⁴

Adequate documentation of program managers' decisions is an essential component of the audit resolution process. The Committee is concerned that program managers may be disregarding the need for such documentation. It is the Committee's hope that future reviews of this critical area will find that this problem no longer exists.

2. Post-audit documentation of expenditures

As noted earlier, auditors frequently question the use of Federal funds because of inadequate documentation. In many such cases, after the audit is completed auditees submit additional information to program officials to be used in the resolution process. In response to a question from Chairman Brooks, OMB stated that, according to recent agency self-evaluations of their audit resolution systems, the allowance of questioned expenditures on the basis of post-audit documentation is the major cause of the disparity between questioned costs and disallowed costs.¹⁵

The allowance of questioned costs based on records supplied after an audit is completed is not an indication of poor performance by the auditors. (The issue of audit quality is discussed later in this report.) Grantees and contractors are responsible for maintaining adequate documentation of their expenditures of Federal funds and these materials should be readily available for inspection by auditors. If essential documentation is missing or otherwise unavailable at the time of the audit, auditors should complete the audit, questioning the undocumented expenditures. Holding the audit open for lengthy periods while the auditee develops the necessary records, with the auditors either remaining on site or leaving and returning at a later date, is a costly and time-consuming process.

The Committee believes that Federal program managers can play an important role in reducing the need for post-audit documentation of questioned costs. As discussed earlier, managers should assure at the outset of a grant or contract that the grantee or contractor has adequate financial systems. This "up-front" involvement by managers can help ensure greater accountability in

¹⁴ Ibid, note 12, p. 2.

¹⁵ Ibid, note 13.

the use of Federal funds and reduce the disparity between questioned costs and disallowed costs.

3. Differing interpretations of laws and regulations

The disparity between questioned costs and disallowed costs is due in part to differing interpretations of applicable laws, regulations, and program requirements by auditors and program officials. While some differences in interpretation are to be expected, agencies can take certain actions to minimize them. One essential step is to provide training to assure that auditors are familiar with the requirements of the program they are auditing. Another is to review the clarity of grant and contract requirements to make sure they can be readily understood by recipients, auditors, and program managers. OMB has indicated that some Federal agencies are, in fact, considering clarifying their regulations.¹⁶ The Committee supports such efforts so long as they are directed solely at clarification and not at weakening standards of accountability in the use of Federal funds.

4. Possible lack of auditor participation in the resolution process

The Committee is concerned about the possible lack of auditor participation in the audit resolution process. Auditors have a vital role to play in this process, and the extent to which they are involved can influence the size of the disparity between questioned costs and disallowed costs.

In its review GAO found that auditors generally did not review program officials' determinations, and at times were not even aware of what decisions had been made on their findings and recommendations. The audits reviewed were considered by program managers in fiscal years 1981 and 1982. The OMB audit resolution circular in effect at that time (Circular A-73, November 27, 1979 Revision) provided for the resolution by a third party of disagreements between auditors and program officials on audit findings and recommendations; however, it did not specifically assign Federal audit officials the responsibility for reviewing program managers' determinations. As noted earlier, Federal audit resolution policies and procedures are now contained in revised Circular A-50, issued in September 1982. A-50 clarifies the role of Federal audit officials in the resolution process by stating that they are responsible for "reviewing responses to audit reports and reporting significant disagreements to the audit followup official." The Committee views this involvement by auditors as an absolutely essential component of the audit resolution process.

The Comptroller General's audit resolution standard specifies another critical role for auditors in the resolution process—following up to find out whether corrective actions determined to be necessary have actually been taken.¹⁷ While under Circular A-50 it is the responsibility of program officials to ensure that corrective action is taken—for example, that audit-related debts are collected or improvements are made in auditees' accounting systems—the Inspectors General and other Federal audit officials should estab-

¹⁶ Id.

¹⁷ Ibid, note 2.

lish appropriate systems to review such implementation. These systems might involve reviewing management's procedures for ensuring that corrective actions are taken, along with an individual review of cases involving a significant amount of Federal funds.

5. Questions of audit quality

In responding to the Committee's request to review agencies' audit resolution procedures, GAO did not attempt to assess the quality of the audits in its sample and thus was not in a position to form a solid conclusion on the extent to which problems with audit quality contribute to the disparity between questioned costs and disallowed costs. According to the GAO, the amount of effort required to conduct such a quality assessment was beyond the scope of its audit resolution study. In the course of its evaluation, however, GAO did find 10 instances in which program managers allowed questioned costs because auditors had improperly questioned the expenditures under review. These errors, which involved a total of \$4.9 million in questioned costs, were primarily the result of auditor miscomputations and misinterpretations of program regulations.¹⁸

In response to a question from Chairman Brooks, OMB stated that, according to recent agency reports on their audit resolution systems, problems with audit quality are not the cause of the disparity between questioned costs and disallowed costs.¹⁹

The Committee views audit quality as a critical aspect of the audit process. Since audits—whether conducted by Federal Inspectors General, State and local auditors, or public accounting firms—are the foundation upon which all followup and resolution activities are based, it is essential that they be of high quality. The Committee has, therefore, recently initiated a comprehensive assessment of the quality of audits of Federal grants to State and local governments and non-profit organizations. On July 27, 1984, Chairman Brooks requested that GAO assist the Committee in this effort.

C. NEED FOR ADDITIONAL OMB AUDIT RESOLUTION GUIDANCE FOR PROGRAM MANAGERS

The frequency of questionable audit resolution decisions by program officials clearly illustrates the need for additional guidance on procedures to be followed in making determinations on audit findings and recommendations. While the review of program managers' decisions by Federal audit officials adds an essential quality control element to the resolution process, the development of specific decisionmaking criteria can help ensure that initial determinations on questioned costs are proper.

OMB Circular A-50 states that agencies' audit followup systems must "specify criteria for proper resolution and corrective action on audit recommendations. . . ." GAO, however, found that while the agencies it reviewed have written audit resolution policies and procedures, "the guidelines generally do not provide specific crite-

¹⁸ Ibid, note 1, p. 15.

¹⁹ Ibid, note 13.

ria for making determinations on questioned costs."²⁰ The Committee believes that OMB should develop such criteria and incorporate them into Circular A-50.

OMB indicated that because of the "number and complexity" of Federal programs, it may not be "practical" for Circular A-50 to include standard criteria for making determinations on audit findings and recommendations. OMB believes that each agency should develop its own criteria "in consultation" with the agency's Inspector General.²¹ The Committee realizes that Federal programs are indeed diverse and that each agency should have some flexibility to design procedures suited to its own programs. Nevertheless, the Committee believes that it is essential for OMB to develop standard audit determination criteria for agencies to use in their audit resolution systems.

D. WEAKNESSES IN OMB'S DEFINITION OF AUDIT RESOLUTION

The definition of audit resolution in Circular A-50 is not consistent with the Comptroller General's audit resolution standard. The GAO standard specifies three steps to the resolution process. The first step is the evaluation of findings and recommendations reported by auditors. The second step is the determination of proper responses to such findings and recommendations. The final step is the completion of necessary corrective action. The Comptroller General emphasizes that the entire process hinges on taking corrective measures:

The audit resolution process begins when the results of an audit are reported to management, and is completed only after action has been taken that (1) corrects identified deficiencies, (2) produces improvements, or (3) demonstrates the audit findings are either invalid or do not warrant management action.²²

OMB, however, defines resolution as completion of the second step in GAO's standard, i.e. that audit findings and recommendations are "resolved" simply when a final determination has been made on the action to be taken.

The Committee believes that there are serious flaws in OMB's definition of audit resolution. In the Subcommittee's hearings, Joseph R. Wright, Jr., Deputy Director of OMB, testified that as of March 31, 1984, Federal agencies had a total of 565 unresolved audits that had exceeded the six month time period prescribed by Circular A-50, 224 involving \$141.7 million in civilian agencies, and 341 totalling \$600 million in the Department of Defense. Mr. Wright expressed pride in these figures:

The number of unresolved audits reported as of March 31, 1984, is a tremendous improvement over the 5,500 reports we originally learned of when the administration took office.²³

²⁰ Id.

²¹ Id.

²² Ibid, note 2.

²³ Ibid, note 13.

However, because of OMB's definition of audit resolution, the numbers cited by Mr. Wright present a misleading picture of the progress made in following up on auditors' findings and recommendations. The figures indicate only that decisions have been made on the appropriate course of action for the audits involved; they do not indicate that essential corrective actions—including the collection of misspent Federal funds—have actually been taken. Such corrective actions are the "bottom line" of the audit resolution process. Unless they are completed, the determination phase of the process is simply an empty exercise. GAO has also expressed serious concerns over OMB's definition of resolution. Its recent report on audit resolution concluded that the use of the definition in Circular A-50 "results in agencies considering auditors' findings and recommendations to be resolved prematurely."²⁴

The Committee's objection to the definition of audit resolution in Circular A-50 is not new. In August 1982, after reviewing a draft revision of the Circular, Chairman Jack Brooks expressed his concerns in a letter to OMB Director David Stockman:

A recent draft of Circular A-50 . . . defined resolution to be complete when action is agreed to on reported audit findings and recommendations. While reaching agreement on appropriate action is important, resolution is not achieved until the problems identified by audits are solved.²⁵

The final version of Circular A-50, issued in September 1982, retained the definition contained in the draft.

In November 1982, Chairman Brooks again wrote Director Stockman on this issue, noting that the definition in Circular A-50 represented a change in Federal audit resolution policy:

. . . Since March 1979 when the Subcommittee on Legislation and National Security held the first of several hearings on the failure of departments and agencies to follow up on audit findings, the term "resolution" has referred to both the process of determining the appropriate action to be taken in response to audit findings and implementing that action. The description of audit resolution in Circular A-73, which previously provided guidance on this matter, was consistent with this definition. And, as recently as October 1981, the draft language in Circular A-50 quite clearly stated that resolution was not to be considered complete until promised action "is actually accomplished."²⁶

In his response to Chairman Brooks, Director Stockman defended OMB's decision to change the definition of resolution, indicating that the revised version is inconsistent with the definition of the term used in the Supplemental Appropriations and Rescission Act of 1980 (Public Law 96-304) and other annual appropriations statutes.

²⁴ Ibid, note 1, p. v.

²⁵ Letter from Chairman Jack Brooks to OMB Director David A. Stockman, August 13, 1982.

²⁶ Letter from Chairman Jack Brooks to OMB Director David A. Stockman, November 8, 1982.

The Supplemental Appropriations and Rescission Act required agencies covered by the Act to "resolve" their backlog of unresolved audits by September 30, 1981, and to "resolve" all new audits within six months of their issuance. The Senate Appropriations Committee report explained that this provision was not intended to require the completion of corrective action within the specified time period but simply to require that a determination be made on audit findings and recommendations. Language similar to this provision was included in several other annual appropriations acts.

The Federal Managers' Financial Integrity Act of 1982 (Public Law 97-255), which was reported by the Government Operations Committee, directed the Comptroller General to prescribe standards for the implementation of the Act, including standards "to ensure the prompt resolution of all audit findings."²⁷ Accordingly, the Comptroller General promulgated "Standards for Internal Control in the Federal Government" in June 1983. This document includes the GAO audit resolution standard. GAO has called on OMB to adopt this standard:

The Federal Managers' Financial Integrity Act of 1982 clearly expresses the Congress' intent to have us (GAO) set the governmentwide standard about what steps constitute audit resolution . . . Given the statutory framework of the Federal Managers' Financial Integrity Act, we believe OMB should revise Circular A-50 and related agency instructions to conform to the Comptroller General's standard on audit resolution—that is, audit findings should not be considered resolved until the actions agreed to are completed.²⁸

In response to a question from Chairman Brooks, GAO indicated that it is not suggesting that Circular A-50 require corrective action within six months after an audit report is issued:

. . . I would like to emphasize that we agree with the A-50 approach that determination should be under a required 6 month time frame. But requiring that the entire resolution be accomplished in 6 months would not be practical in all cases.

We do feel, however, that when costs are reported as resolved, they should be resolved by completing all actions, not just making a determination.²⁹

The Committee strongly believes that audit findings and recommendations are not truly resolved until necessary corrective actions are completed. Furthermore, it is the Committee's position that the definition of audit resolution developed by the Comptroller General pursuant to the Federal Managers' Financial Integrity Act of 1982 takes precedence over the definition currently included in OMB Circular A-50. OMB should revise Circular A-50 to incorporate the Comptroller General's audit resolution standard. Specifically, Circular A-50 should require that a determination be made

²⁷ 31 U.S.C. 3512(b)(2).

²⁸ Ibid, note 1, pp. 21-22.

²⁹ Ibid, note 13.

on auditors' findings and recommendations within six months after the issuance of an audit report, and specify that corrective action be taken as soon as possible after a determination has been made. Findings and recommendations should not be identified as "resolved" until such corrective action is completed.

E. NEED FOR STANDARD DEFINITION OF "QUESTIONED COST"

Circular A-50 provides a standard definition of the term "disallowed cost."³⁰ The Circular does not, however, define "questioned cost." GAO found this lack of OMB guidance has resulted in the development of a number of inconsistent and confusing definitions of the term.

In reviewing the semi-annual reports to Congress of the Inspectors General in the six agencies included in its study, GAO identified several designations to classify and report expenditures questioned by auditors: (1) "cost questioned", (2) "cost recommended for disallowance", and (3) "set aside"/"no opinion"/"unresolved cost".³¹ These terms were used in differing ways; for example, some Inspectors General used "cost questioned" to report expenditures questioned because auditors concluded that a law or regulation had been violated, others used it to report expenditures questioned because of a lack of documentation, and one Inspector General used it to report both types of questioned expenditures. GAO also found that some Inspectors General quantified and reported management improvement findings although these findings did not involve the potential recovery of funds by the Federal Government. GAO concluded that, "One can easily become confused by the various ways IGs categorize questioned costs."³²

The Committee believes that the development of a standard definition of the term "questioned cost" would enable Congress and others to more easily interpret audit data. OMB should develop such a definition and incorporate it into Circular A-50. To enhance the usefulness of questioned cost data, the definition should include separate categories: (1) expenditures questioned because auditors concluded that a Federal law, regulation, or grant or contract provision was violated, and (2) expenditures questioned because of a lack of adequate documentation. In addition, the definition should specify that only findings involving potential recoveries of grant or contract funds by the Federal Government are to be classified as questioned costs.

IV. CONCLUSION

Proper resolution of auditors' findings and recommendations is an essential component of the Federal Government's audit process. Effective resolution practices help ensure that grantees and contractors are held accountable for their expenditure of Federal tax dollars and that scarce audit resources are used effectively and efficiently. Due in large part to the Committee's continuing efforts over the past several years, OMB and the Executive Branch agen-

³⁰ A disallowed cost is "an incurred cost questioned by the audit organization that management has agreed should not be charged to the Government."

³¹ Ibid, note 1, p. 25.

³² Id.

cies have made significant improvements in Federal audit resolution policies and procedures. Nevertheless, more remains to be done.

Federal program officials seek to recover only about 30 to 40 percent of grantee and contractor expenditures questioned by auditors. A significant portion of this disparity between questioned costs and disallowed costs is the result of questionable decisions by program managers on audit findings and recommendations. GAO's review of 325 audits of grantees and contractors found that program managers used questionable procedures in over 25 percent of their decisions to allow costs questioned by auditors. These suspect determinations involved \$163 million in Federal funds. Projecting these results Governmentwide, it appears that hundreds of millions of dollars—if not more—in questioned costs may be improperly allowed each year. The Committee believes this is an intolerable situation that must be corrected. Just as grantees and contractors must be held accountable for their use of Federal funds, so too must program managers be held accountable for their decisions on audit reports. The development of additional audit resolution guidance by OMB can help ensure this accountability.

The definition of audit resolution in Circular A-50 is seriously flawed. As the Committee has insisted for several years and the Comptroller General's audit resolution now specifies, audit findings and recommendations are not "resolved" until necessary corrective actions are completed. The adoption of the GAO standard by OMB will help ensure that the deficiencies identified by auditors are actually corrected and that the audit resolution data reported by OMB and Federal agencies accurately reflect the progress made in implementing such corrective actions.

V. FINDINGS

1. There is frequently a large disparity between the amount of Federal grantee and contractor expenditures questioned by auditors and the amount of such questioned costs that Federal program managers agree should be returned to the Federal Government.

2. Federal program managers often follow questionable procedures in making determinations on audit findings and recommendations. As a result, substantial amounts of expenditures questioned by auditors are allowed improperly.

3. OMB Circular A-50 does not provide specific criteria to be used by program managers in making determinations on audit findings and recommendations. The written audit resolution policies and procedures developed by individual Federal agencies generally do not provide such criteria either.

4. Adequate systems for determining whether corrective actions taken on audit findings and recommendations are an essential part of the audit resolution process.

5. The definition of audit resolution in Circular A-50 is not consistent with the audit resolution standard developed by the Comptroller General pursuant to the Federal Managers' Financial Integrity Act of 1982. The Comptroller General's standard specifies that audit findings and recommendations are not resolved until necessary corrective actions are completed. Under A-50, however, find-

ings and recommendations are considered resolved simply when a final determination has been made on the action to be taken.

6. The lack of a standard definition of the term "questioned cost" has resulted in the development of a number of inconsistent and confusing definitions of the term.

VI. RECOMMENDATIONS

1. The Director of the Office of Management and Budget should revise Circular A-50 to incorporate the audit resolution standard developed by the Comptroller General pursuant to the Federal Managers' Financial Integrity Act of 1982. The Circular should require that a determination be made within six months after the issuance of an audit report, and specify that corrective action be taken as soon as possible after a determination has been made. The Circular should clearly state that audit findings and recommendations are not to be considered resolved until necessary corrective actions are completed.

2. The Director of the Office of Management and Budget should revise Circular A-50 to provide criteria to be used by Federal program managers in making determinations on audit findings and recommendations. Such criteria should, at a minimum, specify that:

(a) When a reaudit of a grantee or contractor is deemed necessary, a determination on the findings and recommendations of the original audit be withheld until the reaudit is completed and a final determination can be made;

(b) Corrective action plans developed by an auditee not be accepted in lieu of seeking recovery of misspent Federal funds;

(c) When corrective action plans are used in cases requiring remedial action by the auditee, a determination on audit findings and recommendations be withheld until the necessary corrective measures are actually implemented; and

(d) Auditee certifications that Federal funds were spent in accordance with applicable laws and regulations be accepted only in situations in which the auditee cannot be expected to have the necessary documentation—such as when its records have been destroyed by fire or flood.

3. The Director of the Office of Management and Budget should revise Circular A-50 to include a standard definition of the term "questioned cost." The definition should include two categories: (1) expenditures questioned because auditors concluded that a Federal law, regulation, or grant or contract provision was violated, and (2) expenditures questioned because of a lack of adequate documentation.

4. All Federal audit organizations should establish and maintain appropriate systems for determining whether necessary corrective actions are taken on audit findings and recommendations.

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